

## Sue Smith

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**From:** Emerton, Paul [Paul.Emerton@schroders.com]  
**Sent:** 29 May 2009 15:44  
**To:** Walker Review  
**Subject:** FW: Governance at UK listed banks

We passed comments on UK listed banks to the Treasury earlier this year and asked that our comments be forwarded to the review being conducted by Sir David Walker. Belatedly, I realised it may help if I forward our comments directly to the Walker review. Accordingly, our comments are set out below. Some of the comments are dated in that, for example, the Turner review is underway but the principles set out in the email, below, still stand.

There is one further item I would like to add. In respect of shareholders engaging with companies, there is a case for shareholders to be more proactive in contacting each other on issues regarding equity investments in which they have a share interest. There is an active level of communication on some issues - executive remuneration, for example - but relatively little on strategy or risk management or pro-active personnel management (in practice, pressure to push for changes of managers tends to arise after a series of errors at a company). Therefore, we and other shareholders should be more willing to work together on these key business issues of, amongst other things, strategy, risk management, pro-active personnel management. There is no need for a formal industry structure - it will be too slow, too consensual and too bureaucratic to achieve much. In our experience, effective engagement with companies requires generally prompt action, direct communication with a selection of other investors and a flexibility regarding how engagement is conducted (for example, whether a group meeting with a company would be more effective than the company meeting each shareholder, or the percentage of share capital needed to encourage change at the company).

Please contact me if you require further information on this submission.

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-----Original Message-----

From: Emerton, Paul  
Sent: 27 February 2009 14:41  
To: 'veda.poon@hm-treasury.gov.uk'  
Cc: Buxton, Richard  
Subject: Governance at UK listed banks

Dear Veda

We are grateful to have been able to participate in Tuesday's Wholesale Markets Forum meeting at HM Treasury and would be pleased to participate in future.

Following our discussion following that meeting, we are writing to let you have some thoughts regarding governance issues at financial institutions, particularly banks and on the role of shareholders. Please pass this on to your team supporting the Walker review into governance at banks: we would be delighted to be involved with, or contribute to, the Walker review.

Regarding failures in the financial system, we note the thoughtful speech by Adair Turner on 21 January 2009 ([http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121\\_at](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at)

.shtml) and in particular, his comments on the stresses in the financial system. In particular, whilst there were problems at banks, they were not the sole reason for the failures in the credit market.

## GOVERNANCE STRUCTURE AT UK BANKS

It is our view that the structure of corporate governance for the UK banks did not fail. There was a failure of judgement regarding implementation of governance, strategy and operational performance but the structure, by itself, did not fail. The failure of judgment occurred in a number of areas by a number of parties, including failure to identify and/or price the risks in the system of wholesale bank funding and (as Turner notes) "failure to identify that the whole system was fraught with market-wide, systemic risk".

We do not believe that any systemic reforms to the governance of UK listed banks would have prevented the crisis.

It follows that while there was a widespread failure of judgement and we can expect and need greater capital controls at a regulatory level, we are concerned there may be unintended consequences if the governance systems of banks have further change imposed. We refer to the example of the Sarbanes-Oxley Act which introduced complex governance rules to the US but failed to prevent the credit market boom and subsequent failure whilst acting as a burden which discouraged potential directors. Ultimately, all stakeholders in banks must rely on the quality of individuals on a bank's board: we consider it essential that the individuals of the highest standard are not subjected to rules and burdens which prevent individuals joining the board of a bank.

Regarding remuneration structures at banks, it is entirely appropriate that banks take a suitably long term approach to rewarding staff, including ensuring that profitable actions over the longer term are rewarded. It follows that this is also an area where regulators will have an interest in order to ensure that remuneration structures do not create undue levels of risk. We are also reminded that the risks of inappropriate remuneration structures are not confined to banks: in 2002, Brambles (a pallet-hire company) announced a profit warning arising from a remuneration scheme that encouraged executives to rent out pallets but did not reward those executives for the return of the pallets after rental. The Brambles example illustrated the dangers of over-focussing on revenue generation and short term targets but despite that example, the practice continues. However, to ban all such remuneration schemes may not be appropriate. By way of example, Sainsbury, under the chairmanship of Phillip Hampton, introduced a pay scheme in 2004/5 that rewarded revenue generation with a greater level of reward if other, longer term, targets were achieved. The pay scheme at Sainsbury has worked successfully.

Accordingly, regulatory guidance on remuneration structures for staff should not be unduly detailed or restrictive in order i) to allow a market in recruitment to continue and function ii) to allow properly considered arrangements to be adopted and iii) to allow the FSA to identify and react to new pay structures. We will therefore be considering the latest FSA guidance carefully, published on Thursday.

## SHAREHOLDERS

The position of shareholders when engaging with companies on strategy, performance and governance is limited by the many-to-one relationship of shareholders and a company: unless a majority of shareholders can be gathered (ignoring, for the moment, regulatory issues), a board cannot

be forced to change policy. Shareholders may work together to force change but a determined board can ignore shareholders unless forced to change by losing a vote. Further difficulties include:

- Shareholders may not share the same view. For example, in March 2008, we saw significantly different views amongst shareholders on whether it was appropriate for the chief executive of a bank to be replaced. The diversity of views is often a strength but it is also a weakness which cannot be resolved without material and damaging interference to the ownership and business interests of beneficial and professional investors.
- Common mis-judgement. A significant part of the market agreed that bank wholesale funding would not disappear, for example.
- Institutional investors have different business models. Some institutions place a greater emphasis on engagement with companies and make a virtue of that engagement. Other fund management firms may have entirely valid business reasons for taking little or no interest in engagement with companies,
- Proprietary information. The identification of potential funding problems for a UK banks (for example) may constitute proprietary research analysis which should not be shared with other parties. It may be necessary to share that proprietary research with other shareholders in order to encourage change at an investee company, thus potentially undermining a source of competitive advantage for the fund manager.
- A significant proportion of shares of UK companies are held by non-UK investors. These investors may have no interest in or may be prevented for regulatory reasons from engaging with companies and/or communicating with other shareholders.
- Regulatory issues: there are occasions where it is necessary to contact the holders of a significant proportion of the company's capital in order to effect change at a company. When the level contacted reaches 29.9%, the Takeover Panel should be informed and shareholders must act to avoid a concert party forming. The risk of a concert party and an obligation to make a bid weakens the ability of shareholders to force change.

If change regarding the governance of banks is required, there may be a case to require that all directors are subject to reelection annually. There is merit in extending this to all companies. However, there is also a risk that annual reelection for only banks would discourage individuals joining bank boards.

A potential issue is whether banks are too complex for a board to control. It can be argued that it unduly stretches a board to control a large, international retail, commercial and investment banking operation. Conversely, HBOS, Bradford and Bingley and Northern Rock did not have investment banking operations yet still struggled and/or failed.

On board level remuneration, the existing provisions on governance remain valid. If board level remuneration failed, it was due to the commercial judgement of shareholders rather than some systemic flaw. By way of example, in 2006 Royal Bank of Scotland changed the performance targets for new long term incentive plan (LTIP) awards by reducing the proportion of awards based on total shareholder return (TSR) and increasing the proportion measured on earnings per share (EPS) growth. We did not support the changes, abstaining on the vote on the remuneration report in in 2006 and voting against the remuneration report and the specific changes to the LTIP in 2007 because i) we disagreed with the RBS view that the performance conditions should be changed because the company had not met the TSR targets. This admission by the company came despite material underperformance against banks and the FTSE 100 when it appeared to us that there was therefore some

linkage between reward and performance; ii) that targets based on EPS may encourage acquisitions by rewarding executives for the purchase of earnings growth despite potential damage to the balance sheet. We made our views known to RBS and its advisers. However, the remuneration changes were heavily supported by shareholders, with substantial majorities of shareholder votes supporting the changes. We also opposed the RBS board on the remuneration report vote in 2008 on this issue and on the payment of an 'exceptional' bonus worth 250% of base salary despite a substantial fall in the value of the company during 2007: I understand that of the shares voted at the 2008 RBS AGM, approximately 88% were voted for the board, 3% abstained and 8% were voted against the remuneration report resolution. (At the 2008 AGM, we also voted against powers for the company to issue further shares: we considered that the board needed to change the management of RBS as a condition of receiving further money from shareholders: we had also made that view known to the company early in 2008.

Please contact me if you have any questions or require further information regarding our views.

Yours sincerely

Paul Emerton

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